Improving predictability and transparency of the Stability and Growth Pact

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Presidency note

Introduction

The European Union's Stability and Growth Pact consists of a rules-based framework with both preventive and corrective elements. It aims at achieving macroeconomic stability in the EU and safeguarding the sustainability of public finances, through a rules-based system that allows commitments to be enforced and for all Member States to be treated equally, while respecting the principle of subsidiarity in government decisions on tax and public expenditure. Thus it serves the goals of fiscal sustainability, an efficient and effective allocation of budgetary resources and anti-cyclical behaviour.

These goals give the basic economic rationale. But beyond the economic rationale there is the political-economic reality. Experience shows that budgetary rules – i.e. a fiscal framework – are superior over discretion in fiscal policy making and that a well-designed fiscal framework has three characteristics:

- Simplicity
- Flexibility
- Policy credibility / predictability

There are trade-offs between simplicity, predictability and flexibility. Allowing more flexibility ex-post reduces predictability. But spelling out flexibility options in detail ex-ante, comes at the expense of simplicity. It is therefore crucial to strike a proper balance when designing fiscal rules.

The European fiscal framework has become rather complex, due to continuous fine-tuning of the rules. The definition of objectives and the monitoring of compliance have thus become hard to predict. This has in turn contributed to a lack of ownership by national policymakers. This gradual trend should be reversed. This note discusses two main avenues to improve the functioning of the Pact: 1. Use of a single indicator in assessing compliance with the rules 2. A medium-term orientation.

Two avenues to improve the functioning of the Pact

1. A single indicator

The sheer number of indicators in the current framework poses a massive challenge for the national implementation of the fiscal framework. It contains targets, upper limits, and benchmarks for the nominal balance, structural balance, expenditure growth and debt development. The preventive arm adds to these indicators an overall assessment while a so called 'careful analysis' is part of the corrective arm.

The structural balance is an anchor in our system, deeply embedded in the legal framework. Importantly so, the structural balance anchors the outcome of fiscal policies. However, the structural balance is unobservable, volatile and subject to major revisions, even ex-post. These revisions stem mostly from the economic cycle which alters potential output estimates. Substantial efforts have been made to improve the structural balance estimates, but it remains highly doubtful whether fine-tuning this highly complex indicator will yield sufficient improvements. As a result, Member States are held accountable for an indicator which to a crucial extent lies beyond their control.

In addition to the structural balance, a case can thus be made to look for an indicator that anchors input in the fiscal framework and provides a solid base for national budgetary strategy and decision-making. An indicator that serves as a real-time anchor for guiding policymaking and for which policymakers can be held accountable ex-ante as well as ex-post. Both the Commission (see background paper) and other institutions such as Bruegel and the IMF have pointed to an expenditure rule as an operational target that can help overcome current problems in fiscal surveillance. A single indicator should be consistently applied in both the preventive and corrective arms of the Pact and should ensure that countries in the corrective arm of the Pact are required to pursue a fiscal strategy that is at least as ambitious as that required from Member States in the preventive arm of the Pact.

As reflected in the Commission's note, the design of an expenditure rule also requires a balancing act. Nevertheless, the benefit of a well-designed expenditure rule is that it is under more direct control of policy makers, thus significantly increasing predictability. Moreover, an expenditure rule allows for macroeconomic stabilisation. And an expenditure rule can be made consistent with the structural balance, which is deeply embedded in our current framework, as a medium-term target.

2. A medium-term orientation

The benefits of a medium-term orientation of budgeting are overriding. It allows for a better allocation of expenditures, it helps ensure prudent fiscal decision-making over the medium term, it increases predictability and transparency, as well as accountability of policymakers, and importantly it increases the effectiveness in cyclical stabilisation.

The current cycle of European fiscal surveillance is foremost an annual cycle, where politicians are held accountable for year-on-year changes in unobservable indicators. For politicians to feel ownership of the fiscal rules it should be clear, well in advance of their national budgetary processes, what effort is required – see also the recent letter to the Commission by a number of Finance Ministers. However, currently there is a continuous possibility that budgetary plans need to be adapted. Announced measures to meet the criteria can prove to be insufficient when a forecast is updated, or may turn out to not have been necessary at all.

A more medium-term orientation could foster the quality of public finances and structural reforms. Thus budgetary planning should be as medium-term oriented as possible. The European fiscal framework should allow for approval at the European level of national medium term plans on cornerstone variables such as the projected (structural) deficit path, while at the same time, monitoring on a yearly basis the execution of the plans to ensure that annual budgetary obligations are met on a more operational variable such as the expenditure benchmark.

Issues for discussion

The Presidency would like to propose the following questions for the discussion:

- Do you agree that the current fiscal framework has become too complex?
- Should the fiscal framework rely more on the expenditure benchmark for the annual assessments of budgetary plans of Member States?
- Should further work be done to explore both the use of the expenditure benchmark as well as the medium term orientation of our fiscal framework?